

section 4943(a) with respect to the holdings of a private foundation in any business enterprise, if, at the close of the taxable period (as defined in section 4943(d)(2) and § 53.4943-9) with respect to such holdings the foundation still has excess business holdings in such enterprise, there is imposed a tax under section 4943(b) equal to 200 percent of the value of such excess holdings as of the last day of the taxable period.

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§ 53.4943-3 Determination of excess business holdings.

(a) *Excess business holdings*—(1) *In general.* For purposes of section 4943, the term “excess business holdings” means, with respect to the holdings of any private foundation in any business enterprise (as described in section 4943(d)(4)), the amount of stock or other interest in the enterprise which, except as provided in § 53.4943-2(a)(1), the foundation, or a disqualified person, would have to dispose of, or cause the disposition of, to a person other than a disqualified person (as defined in section 4946(a)) in order for the remaining holdings of the foundation in such enterprise to be permitted holdings (as defined in paragraphs (b) and (c) of this section). If a private foundation is required by section 4943 and the regulations thereunder to dispose of certain shares of a class of stock in a particular period of time and other shares of the same class of stock in a shorter period of time, any stock disposed of shall be charged first against those dispositions which must be made in such shorter period.

(2) *Example.* The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X has outstanding 100 shares of voting stock, with each share entitling the holder thereof to one vote. F, a private foundation, possesses 20 shares of X voting stock representing 20 percent of the voting power in X. Assume that the permitted holdings of F in X under paragraph (b)(1) of this section are 11 percent of the voting stock in X. F, therefore, possesses voting stock in X representing a percentage of voting stock in excess of the percentage permitted by such paragraph. Such excess per-

centage is 9 percent of the voting stock in X, determined by subtracting the percentage of voting stock representing the permitted holdings of F in X (i.e., 11 percent) from the percentage of voting stock held by F in X (i.e., 20 percent). (20% - 11% = 9%). The excess business holdings of F in X are an amount of voting stock representing such excess percentage, or 9 shares of X voting stock (9 percent of 100).

(b) *Permitted holdings in an incorporated business enterprise*—(1) *In general*—(i) *Permitted holdings defined.* Except as otherwise provided in section 4943(c) (2) and (4), the permitted holdings of any private foundation in an incorporated business enterprise (including a real estate investment trust, as defined in section 856) are:

(A) 20 percent of the voting stock in such enterprise reduced (but not below zero) by

(B) The percentage of voting stock in such enterprise actually or constructively owned by all disqualified persons.

(ii) *Voting stock.* For purposes of this section, the percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors, with treasury stock and stock which is authorized but unissued being disregarded. Thus, for example, if a private foundation holds 20 percent of the shares of one class of stock in a corporation, which class is entitled to elect three directors, and such foundation holds no stock in the other class of stock, which is entitled to elect five directors, such foundation shall be treated as holding 7.5 percent of the voting stock because the class of stock it holds has 37.5 percent of such voting power, by reason of being able to elect three of the eight directors, and the foundation holds one-fifth of the shares of such class (20 percent of 37.5 percent is 7.5 percent). The fact that extraordinary corporate action (e.g., charter or by-law amendments) by a corporation may require the favorable vote of more than a majority of the directors, or of the outstanding voting stock, of such corporation shall not alter the determination of voting power of stock in such corporation in accordance with the two preceding sentences.

(2) *Nonvoting stock as permitted holdings*—(i) *In general.* In addition to those holdings permitted by paragraph (b)(1) of this section, the permitted holdings of a private foundation in an incorporated business enterprise shall include any share of nonvoting stock in such enterprise held by the foundation in any case in which all disqualified persons hold, actually or constructively, no more than 20 percent (35 percent where third persons have effective control as defined in paragraph (b)(3)(ii) of this section) of the voting stock in such enterprise. All equity interests which do not have voting power attributable to them shall, for purposes of section 4943, be classified as nonvoting stock. For this purpose, evidences of indebtedness (including convertible indebtedness), and warrants and other options or rights to acquire stock shall not be considered equity interests.

(ii) *Stock with contingent voting rights and convertible nonvoting stock.* Stock carrying voting rights which will vest only when conditions, the occurrence of which are indeterminate, have been met, such as preferred stock which gains such voting rights only if no dividends are paid thereon, will be treated as nonvoting stock until the conditions have occurred which cause the voting rights to vest. When such rights vest, the stock will be treated as voting stock that was acquired other than by purchase, but only if the private foundation or disqualified persons had no control over whether the conditions would occur. Similarly, nonvoting stock which may be converted into voting stock will not be treated as voting stock until such conversion occurs. For special rules where stock is acquired other than by purchase, see section 4943(c)(6) and the regulations thereunder.

(iii) *Example.* The provisions of this paragraph (2) may be illustrated by the following example:

Example. Assume that F, a private foundation, holds 10 percent of the single class of voting stock of corporation X, and owns 20 shares of nonvoting stock in X. Assume further that A and B, the only disqualified persons with respect to F, hold 10 percent of the voting stock of X. Under the provisions of paragraph (b)(1) of this section the 10 percent of X voting stock held by F will be classified

as permitted holdings of F in X since 20 percent less the percentage of voting stock held by A and B in X is 10 percent. In addition, under the provisions of this (2), the 20 shares of X nonvoting stock will qualify as permitted holdings of F in X since the percentage of voting stock held by A and B in X is no greater than 20 percent.

(3) *Thirty-five-percent rule where third person has effective control of enterprise*—

(i) *In general.* Except as provided in section 4943(c)(4), paragraph (b)(1) of this section shall be applied by substituting 35 percent for 20 percent if:

(A) The private foundation and all disqualified persons together do not hold, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and

(B) The foundation establishes to the satisfaction of the Commissioner that effective control (as defined in paragraph (b)(3)(ii) of this section) of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualified persons.

(ii) *“Effective control” defined.* For purposes of this subparagraph, the term “effective control” means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation’s directors, effective control is in the hands of those individuals.

(4) *Two percent de minimis rule*—(i) *In general.* Under section 4943(c)(2)(C), a private foundation is not treated as having excess business holdings in any incorporated business enterprise in which it (together with all other private foundations (including trusts described in section 4947(a)(2)) which are described in section 4946(a)(1)(H)) actually or constructively owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock. If, however, the private foundation, together with all other private

foundations which are described in section 4946(a)(1)(H), actually or constructively owns more than 2 percent of either the voting stock or the value of the outstanding shares of all classes of stock in any incorporated business enterprise, all the stock in such business enterprise classified as excess business holding under section 4943 is treated as excess business holdings. For purposes of this paragraph, any stock owned by a private foundation which is treated as held by a disqualified person under section 4943(c)(4)(B), (5), or (6) shall be treated as actually owned by the private foundation. See paragraph (b)(1) of § 53.4941(d)-4 for the determination of excess business holdings without regard to section 4943(c)(2)(C) for purposes of applying section 101(C)(2)(B) of the Tax Reform Act of 1969 (83 Stat. 533).

(ii) *Examples.* The provisions of this subparagraph may be illustrated by the following examples:

Example (1). F, a private foundation, owns 1 percent of the single class of voting stock and 1 percent in value of all the outstanding shares of all classes of stock in X corporation. No other private foundation described in section 4946(a)(1)(H) owns any stock in X. All of the stock owned by F in X would be excess business holdings under section 4943(c)(1) if section 4943(c)(2)(C) were inapplicable. F owns no other shares of stock in X. Since F owns more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock in X, under section 4943(c)(2)(C) none of the stock in X owned by F is treated as excess business holdings.

Example (2). Assume the facts as stated in Example (1), except that F and T, a controlled private foundation under section 4946(a)(1)(H), together own 1 percent of all the voting stock and 1 percent in value of all the outstanding shares of all classes of stock in X. All of the stock in X owned by F and T would be excess business holdings under section 4943(c)(1) if section 4943(c)(2)(C) were inapplicable. Since F and T together owned no more than 2 percent of the voting stock and no more than 2 percent in value of all outstanding shares of all classes of stock in X, under section 4943(c)(2)(C) none of the stock in X owned by either F or T is treated as excess business holdings.

Example (3). Assume the facts as stated in Example (1), except that F owns 3 percent of the voting stock in X, 2 percent of which is treated as held by P, a disqualified person of F, under section 4943(c)(4)(B). Under subdivision (i) of this subparagraph, the 2 percent of

the stock in X owned by F which is treated as held by P under section 4943(c)(4)(B) is treated as actually owned by F for purposes of section 4943(c)(2)(C). Consequently, all of the X stock owned by F is treated as excess business holdings under section 4943(c)(2)(C). However, only 1 percent of the stock in X is subject to tax under section 4943(a), since the other 2 percent is treated as owned by a disqualified person under section 4943(c)(4)(B) for purposes of determining the tax upon F under section 4943(a).

(c) *Permitted holdings in an unincorporated business enterprise—(1) In general.* The permitted holdings of a private foundation in any business enterprise which is not incorporated shall, subject to the provisions of subparagraphs (2), (3), and (4) of this paragraph, be determined under the principles of paragraph (b) of this section.

(2) *Partnership or joint venture.* In the case of a partnership (including a limited partnership) or joint venture, the terms “profits interest” and “capital interest” shall be substituted for “voting stock” and “nonvoting stock,” respectively, wherever those terms appear in paragraph (b) of this section. The interest in profits of such foundation (or such disqualified person) shall be determined in the same manner as its distributive share of partnership taxable income. See section 704(b) (relating to the determination of the distributive share by the income or loss ratio) and the regulations thereunder. In the absence of a provision in the partnership agreement, the capital interest of such foundation (or such disqualified person) in a partnership shall be determined on the basis of its interest in the assets of the partnership which would be distributable to such foundation (or such disqualified person) upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(3) *Sole proprietorship.* For purposes of section 4943, a private foundation shall have no permitted holdings in a sole proprietorship. In the case of a transfer by a private foundation of a portion of a sole proprietorship, see paragraph (c)(2) of this section (relating to permitted holdings in partnerships). For the treatment of a private foundation's ownership of a sole proprietorship prior to May 26, 1969, see § 53.4943-4.

(4) *Trusts and other unincorporated business enterprises*—(i) *In general.* In the case of any unincorporated business enterprise which is not described in paragraph (c) (2) or (3) of this section, the term “beneficial interest” shall be substituted for “voting stock” wherever the term appears in paragraph (b) of this section. Any and all references to nonvoting stock in paragraph (b) of this section shall be inapplicable with respect to any unincorporated business enterprise described in this subparagraph.

(ii) *Trusts.* For purposes of section 4943, the beneficial interest of a private foundation or any disqualified person in a trust shall be the beneficial remainder interest of such foundation or person determined as provided in paragraph (b) of § 53.4943-8.

(iii) *Other unincorporated business enterprises.* For purposes of section 4943, the beneficial interest of a private foundation or any disqualified person in an unincorporated business enterprise (other than a trust or an enterprise described in paragraph (c) (2) or (3) of this section) includes any right to receive a portion of distributions of profits of such enterprise, and, if the portion of distributions is not fixed by an agreement among the participants, any right to receive a portion of the assets (if any) upon liquidation of the en-

terprise, except as a creditor or employee. For purposes of this subparagraph, a right to receive distributions of profits includes a right to receive any amount from such profits (other than as a creditor or employee), whether as a sum certain or as a portion of profits realized by the enterprise. Where there is no agreement fixing the rights of the participants in such enterprise, the interest of such foundation (or such disqualified person) in such enterprise shall be determined by dividing the amount of all equity investments or contributions to the capital of the enterprise made or obligated to be made by such foundation (or such disqualified person) by the amount of all equity investments or contributions to capital made or obligated to be made by all participants in the enterprise.

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). Corporation X has outstanding 100 shares of voting stock, with each share entitling the holder thereof to one vote. Assume that F, a private foundation, possesses 30 shares of X voting stock, and that A and B, the only disqualified persons with respect to F, together own 10 shares of X voting stock. The excess business holdings of F in X are 20 shares of X voting stock, determined as follows:

| | |
|--|-----|
| <i>(i) Determination of voting stock percentages</i> | |
| (a) Total number of outstanding votes in X | 100 |
| (b) Total number of votes in X held by F | 30 |
| (c) Total number of votes in X held by A and B | 10 |
| (d) Percentage of voting stock in X held by F (item (b) divided by item (a)) (percent) | 30 |
| (e) Percentage of voting stock in X held by A and B (item (c) divided by item (a)) (percent) | 10 |
| <i>(ii) Determination of permitted holdings of voting stock</i> | |
| (a) Percentage of voting stock in X held by A and B (percent) | 10 |
| (b) Permitted holdings of voting stock by F in X (20 pct less item (a)) (percent) | 10 |
| <i>(iii) Determination of excess business holdings</i> | |
| (a) Percentage of voting stock in X held by F (percent) | 30 |
| (b) Permitted holdings of voting stock by F in X (percent) | 10 |
| (c) Item (a) less item (b) (percent) | 20 |
| (d) Excess business holdings of F in X (i.e., an amount of X voting stock representing a percentage of voting stock equivalent to that in item (c)) (shares) | 20 |

Example (2). F, a private foundation, is a partner in P partnership. In addition, A and B, the only disqualified persons with respect to F, are partners in P. The partnership agreement of P contains no provisions regarding the sharing of profits by, and the respective capital interests of, the partners.

(i) assume that, under section 704(b), F's distributive share of P taxable income is determined to be 20 percent. In addition, assume that under such section, A and B are determined to have a 4-percent distributive share each of P taxable income. Accordingly, F holds a 20-percent profits interest in P, and A and B hold an 8-percent profits interest in

P. Assuming that the provisions of section 4943(c)(2)(B) do not apply, the permitted holdings of F in P are 12 percent of the profits interest in P, determined by subtracting the percentage of the profits interest held by A and B in P (i.e., 8 percent) from 20 percent. (20 percent - 8 percent = 12 percent.) F, therefore, holds a percentage of the profits interest in P in excess of the percentage permitted by § 53.4943-3(b)(1). The excess business holdings of F in P are a percentage of the profits interest in P equivalent to such excess percentage, or 8 percent of the profits interest in P, determined by subtracting the permitted holdings of F in P (i.e., 12 percent) from the percentage of the profit interest held by F in P (i.e., 20 percent) (20 percent - 12 percent = 8 percent.)

(ii) Assume that, under the partnership agreement, F would be entitled to a distribution of 20 percent of P's assets upon F's withdrawal from P and to a distribution of 30 percent of P's assets upon the liquidation of P's profits interest held by F in P (i.e., 20 percent) (20 percent - 12 percent = 8 percent), of P. F, therefore, holds a 30-percent capital percentage of the assets of P distributable to F upon F's withdrawal from P, or the percentage of such assets distributable to F upon the liquidation of P. Since the percentage of the profits interest held by A and B in P is less than 20 percent, such 30-percent capital interest will be included in the permitted holdings of F in P.

§ 53.4943-4 Present holdings.

(a) *Introduction*—(1) *Section 4943 (c)(4) in general.* (i) Paragraph (4) of section 4943(c) prescribes transition rules for a private foundation which, but for such paragraph, would have excess business holdings on May 26, 1969. Section 4943(c)(4) provides such a foundation with protection from the initial tax on excess business holdings in two ways. First, the entire interest of such a foundation in any business enterprise in which such a foundation, but for section 4943(c)(4), would have had excess business holdings on May 26, 1969, is treated under section 4943(c)(4)(B) as held by disqualified persons for a certain period of time (the "first phase"). The effect of such treatment is to prevent a private foundation from being subject to the initial tax with respect to its May 26, 1969, interest during the first phase holding period and also to prevent the foundation from purchasing any additional business holdings in such business enterprise during such period (unless the combined holdings of the foundation and all disquali-

fied persons fall below the 20 percent (or 35 percent, if applicable) figure prescribed by section 4943(c)(2)). Second, section 4943(c)(4)(A)(i) initially increases the percentage of permitted holdings of such a foundation to a percentage equal to the difference between:

(A) The percentage of combined holdings of the foundation and all disqualified persons in such business enterprise on May 26, 1969 (subject to a 50 percent maximum), and

(B) The percentage of holdings of all disqualified persons.

The percentage referred to in paragraph (a)(1)(i)(A) of this section is referred to in this section as the "substituted level". This "substituted level" is then reduced by the "downward ratchet rule" prescribed by section 4943(c)(4)(A)(ii) and paragraph (d)(3) of this section for certain dispositions by such foundation or by disqualified persons. The primary purpose of the substituted level is to indicate what the permitted holdings in such business enterprise will be immediately after the expiration of the first phase holding period. Thereafter, the permitted holdings of a private foundation itself are further limited to a maximum 25 percent interest in such business enterprise by section 4943(c)(4)(D) as soon as the combined holdings of all disqualified persons in such business enterprise exceed 2 percent (of the voting stock). If the combined holdings of all disqualified persons at no time exceed 2 percent (of the voting stock) during the 15 years following the first phase (the "second phase"), then the substituted level is reduced to a 35 percent maximum after the second phase.

(ii) Paragraph (a)(1)(i) of this section may be illustrated by the following example:

Example. On May 26, 1969, private foundation P held a 5 percent interest in corporation X (voting stock and value). On such date disqualified persons held a 16 percent interest in X (voting stock and value). Assume that except for section 4943(c)(4), P would have had a 1 percent interest in X which would have constituted excess business holdings. Therefore, section 4943(c)(4)(B) applies and P's 5 percent interest in X is treated as held by a disqualified person during the 10-year period beginning May 26, 1969. Since